COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E 03-47

BOSTON EDISON COMPANY
CAMBRIDGE ELECTRIC LIGHT COMPANY
COMMONWEALTH ELECTRIC COMPANY
NSTAR GAS COMPANY

PENSION/PBOP ADJUSTMENT MECHANSIM
TARIFF FILING

DIRECT TESTIMONY OF DAVID J. EFFRON

On behalf of

THE OFFICE OF THE ATTORNEY GENERAL

July 22, 2003

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in approximately two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New

York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Office of the Attorney General.

Q. What is the purpose of your testimony?

A. Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company (together "NSTAR" or "the Company") have requested authorization from the Department to implement a reconciliation adjustment mechanism (a "PAM") for costs associated with pensions and postretirement benefits other than pensions ("PBOP"). The purpose of this testimony is to address the request by NSTAR to implement the PAM.

Q. Please summarize the conclusions of your testimony.

A. The Company has not established that the PAM is necessary at this time to avoid financial impairment. In addition, the proposed PAM represents a selective attempt to recover increases in certain costs since the Company's last base rate cases without any recognition of offsetting decreases in revenue requirements. The proposed PAM also includes improper elements. Therefore, the Department should not approve the PAM requested by NSTAR.

III. PROPOSED PENSION ADJUSTMENT MECHANISM

A. DESCRIPTION OF PROPOSED MECHANISM

Q. Please describe the PAM being proposed by NSTAR.

A. The PAM is an annual surcharge to the Company's base distribution rates. Its purpose is to establish an increased level of pension and PBOP costs currently being recovered in distribution rates and to reconcile the pension and PBOP costs being recovered through rates to the pension and PBOP costs accrued on the Company's books of account pursuant to the relevant accounting standards.[1] The PAM consists of three major components.

The first component is the difference between the average of the pension and PBOP current cash contributions, based on the average contributions for the years 2001-2003, and the pensions and PBOP presently being recovered through base rates, based on the amounts reflected in the cost of service in the Company's most recent base rate cases. This component would increase the annual recovery by approximately $40 million.

The second component is a three-year amortization of the annual difference between the recovery of pension and PBOP costs and the costs accrued for financial reporting purposes pursuant to SFAS 87 and SFAS 106. The PAM would also include carrying charges on any unamortized balances of under or over recoveries of the difference between the current recovery and the accrual pursuant to SFAS 87 and SFAS 106.

The third component is a return on the cumulative excess of cash contributions to the pension and PBOP funds over the costs accrued on the Company's books of account, net of deferred income taxes. As of the end of 2002 the prepaid pension and PBOP balance was approximately $202 million. The estimated first year carrying charges based on this balance would be approximately $20.7 million.

[1] Pension costs are accrued for financial reporting purposes pursuant to Statement of Financial Accounting Standards ("SFAS") 87. PBOP costs are accrued for financial reporting purposes pursuant to SFAS 106.

The annual surcharge would be recovered by a per kWh charge for the electric distribution companies and a per therm charge for NSTAR Gas. The PAM would also reconcile the amount recovered through actual sales to the expected recovery through forecasted sales.

B. NEED FOR PROPOSED MECHANISM

Q. Has NSTAR established that the proposed PAM is a necessary and appropriate mechanism to implement at this time?

A. No. As a general matter, reconciliation mechanisms are contrary to sound ratemaking practice, as such mechanisms tend to either reduce or eliminate incentives to control costs. The Company presents the PAM as a reconciling mechanism that would address the volatility of pension and PBOP costs and mitigate potential financial impairment resulting from such volatility. However, the Company has not provided any measurement of the volatility of pension and PBOP costs or any measurement of how the magnitude of changes in these expenses relate to overall revenue requirements; nor has the Company compared the magnitude or volatility of pension and PBOP costs relative to other costs for which there is no adjustment mechanism.

Q. Has the Company presented any data or analysis that establishes the potential for the volatility of the pension and PBOP expense to impair its financial integrity?

A. No. Both pension and PBOP expenses are accrued by the Company pursuant to financial accounting standards, which require certain actuarial and financial assumptions. While it is true that changes in those assumptions can cause pension and PBOP expenses to fluctuate, just about all other expenses included in the Company's base rate cost of service are also subject to fluctuation. The Company has not explained why pension and PBOP costs should be treated differently from these other expenses that go into the base rate revenue requirement. Further, the Company has not presented any analysis showing that the fluctuations in pension and PBOP costs are of such a magnitude that they have the potential to impair its financial integrity.

Q. If the Company could demonstrate that, absent the implementation of the proposed PAM, the fluctuations in the pension and PBOP pose a significant risk, then is its proposal complete?

A. No. The Company does not presently have any pension and PBOP reconciliation mechanism in place, nor were any such mechanisms in place at the time of the last base rate cases. Thus, to the extent the volatility of pension and PBOP expense causes financial risks, such risks are implicitly incorporated into the cost of common equity. If a reconciliation mechanism is approved, then such financial risks are transferred to the Company's customers. If the financial risks are transferred, then the Company's common stock is less risky, and the authorized return on common equity should be reduced to incorporate the reduced level of risk. It would be inappropriate to incorporate the proposed PAM without an adjustment to the cost of service to recognize the reduced risk of the NSTAR common equity.

Q. Has the Company established that increases in pension and PBOP expense are actually causing it to experience a revenue deficiency?

A. No. The PAM as proposed by NSTAR is a selective adjustment, seeking recovery of factors that have increased the Company's revenue requirements since its last base rate cases without any recognition of other factors that may have decreased its revenue requirements.

Q. Is there any evidence to indicate that the Company's rates are, in fact, adequate to cover its current and forecasted pension and PBOP expenses?

A. Yes. First, it should be noted that in 2002, the latest calendar year for which actual data are available, the Company's own analysis shows that pension and PBOP expense accrued recorded pursuant to SFAS 87 and SFAS 106 were less than the amount recovered in base rates. The response to D.T.E Data Request 1-2 (Revised) shows a pension expense of $8.4 million recorded pursuant to SFAS 87 in 2002. This is approximately $7.2 million less than the $15.6 million of pension expense that NSTAR calculated that it recovered in base rates in that year[2]. With regard to PBOP, the expense recorded pursuant to SFAS 106 in 2002 was $21.8 million, which approximated the $21.5 million that NSTAR calculated that it recovered in base rates. Thus, the expense accrued for pensions and PBOP together in 2002 was $6.9 million less the amount recovered in rates, as calculated by NSTAR. It is the

[2] This assumes that NSTAR has properly calculated the pension and PBOP currently recovered in rates. As explained later, NSTAR appears to have understated the current recovery.

forecasted pension and PBOP expenses in years after 2002 that NSTAR claims are greater than the expenses being recovered through rates.

It is not at all clear that, even assuming that the forecasts for pension and PBOP expense for 2003 and later years are accurate, NSTAR could establish that the increases in those expenses would actually cause a revenue deficiency if not recovered through a separate reconciliation mechanism. On my Schedule DJE-1, I have calculated the return on common equity earned by NSTAR in 2002. As can be seen on this schedule, after eliminating the effect of the write-down of the RCN investment, the earned return on average common equity in 2002 was 14.00%.[3] I believe this to be well in excess of the return on common equity that the Department would authorize in a rate case, based on current market conditions.

I am not claiming that this conclusively establishes that NSTAR has a revenue excess. However, in my opinion, it would be inappropriate to establish a separate mechanism to recover a forecasted increase in one element of the cost of service, when there is substantial question that the forecasted increase in that cost would cause a revenue deficiency. Put simply, NSTAR should not be allowed to impose a rate increase on its customers by means of a new automatic adjustment mechanism when it is possible that a complete revenue requirement analysis might establish that a rate decrease is warranted.

[3] Based on the net income in 2000 and 2001, it appears that the earned return on common equity would be in approximately the same range in those years.

Q. Is approval of the proposed PAM necessary to avoid a charge to equity, through other comprehensive income, of "Additional Minimum Liability" (Exhibit NSTAR-JJJ, Pages 14-16)?

A. No. To my knowledge, the Department has always permitted recovery of reasonable and prudent pension and PBOP expenses through the cost of service. Thus, to the extent that the Company's pension and PBOP costs are reasonable and prudent, there is reasonable assurance that the Department will establish rates that are adequate to generate revenues that will recover those costs. Accordingly, pursuant to Statement of Financial Accounting Standards No. 71, Paragraph 9, the Company can book a regulatory asset to offset the Additional Minimum Liability and would not have to write off the prepaid pension asset.[4]

C. IMPROPER ELEMENTS IN PROPOSED MECHANISM

Q. Are there specific problems with the PAM proposed by NSTAR?

A. Yes. First, the proposal to recover carrying charges on the net prepaid pension and PBOP balance carried on the Company's balance sheet is inappropriate. Second, the calculations of the pension and PBOP expense currently being recovered in rates, to which the actual current expenses would be compared, are incorrect. Third, the carrying cost rates used in the calculation of the PAM factor are not proper.

[4]Obviously, if any of the costs were found to be unreasonable or imprudent, then they would not be recoverable; in that hypothetical circumstance no regulatory asset would be appropriate for the unreasonable or imprudent costs.

Q. Why is the Company's proposal to recover carrying charges on the prepaid pension and PBOP balance carried on the Company's balance sheet not appropriate?

A. It is my understanding that it has not been the general practice of the Department to include prepaid pension balances, to the extent such balances relate to differences between the pension cost pursuant to SFAS 87 and cash contributions to the pension plan, in utility companies' rate bases. In effect then, allowing recovery of carrying charges on the prepaid pension and PBOP balance in the reconciliation mechanism would allow the Company to recover through a surcharge to base rates that for which the Department has denied recovery in the base rate revenue requirement. In addition, if the Company's present rates are adequate to provide a return on that prepaid pension and PBOP balance[5], then allowing a return on that balance as a component of the PAM would provide a double recovery to the Company.

Further, the prepaid pension balance reflects the difference between the pension cost pursuant to SFAS 87 and cash contributions to the pension plan, not the difference between the pension expense recovered in rates and cash contributions to the pension plan. Therefore, the prepaid pension cost on the Company's balance sheet is not a measure of the cash required by investors to cover the difference between the actual recovery of pension expense in rates and cash disbursements to the pension plan.

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[5] And, based on the actual earned return on common equity in 2002, it appears that the Company's present rates do implicitly provide a return on those prepayments.

Q. Why are the calculations of the pension and PBOP expense currently being recovered in rates incorrect?

A. As explained by the Company, the Department approved the pension and PBOP expenses included in currently effective distribution rates in the following cases:

Boston Edison	D.P.U. 92-92
Commonwealth Electric	D.P.U. 90-331
Cambridge Electric Light	D.P.U. 92-250
NSTAR Gas	D.P.U. 91-60

Pursuant to the electric Restructuring Act, the distribution rates of the electric companies were unbundled with the distribution rates being separately determined based on the distribution cost of service in the following cases:

Boston Edison	D.P.U. /D.T.E. 96-23
Commonwealth Electric	D.P.U. /D.T.E. 97-111
Cambridge Electric Light	D.P.U. /D.T.E. 97-111

Thus, the base amounts the pension and PBOP expense currently being recovered in rates were set in cases more than ten years ago and then, for the electric companies, allocated to distribution rates based on the cost of service studies in the restructuring cases. The Company has not adjusted the amounts being recovered in rates for growth in customers, sales, or other billing determinants since the early 1990's, when the amounts included in the total cost of service were established. Thus, to the extent that there has been system growth since the early 1990's the Company has understated the pension and PBOP expenses presently being recovered through rates. In one sense, there has never really been any explicit determination of the pension and PBOP expense currently being recovered in distribution rates by the electric companies, as there has never has been a stand-alone distribution rate case for any of these companies.[6]

Q. Why are the carrying cost rates used in the calculation of the PAM factor not proper?

A. The carrying cost rates reflect the costs of capital established years ago, not the current cost of capital. For example, the Company is proposing to use a pre-tax carrying cost rate of 15.53% for NSTAR Gas, based on that company's authorized rate of return in D.P.U. 91-60. I am not a cost of capital expert, but I am reasonably sure that a pre-tax rate of 15.53% is well in excess of the rate of return that the Department would authorize for NSTAR Gas based on current market conditions.

Q. Please summarize your testimony.

A. The Department should not approve the reconciliation adjustment mechanism requested by NSTAR. The Company has not shown that pension and PBOP expenses should be treated differently from other expenses included in the distribution cost of service. Further, the proposed mechanism is a selective attempt to recover forecasted increases in certain costs without any determination of whether such forecasted increases will actually cause a revenue deficiency. Finally, the mechanism proposed by the Company contains several improper elements,

[6] In effect, there have been so many substantial changes since the early 1990's, it can become extremely difficult in some instances to determine exactly what is, or is not, being recovered in distribution rates.

which make it unsuitable as a method of reconciling and recovering pension and PBOP costs.

Q. Does this conclude your testimony?

A. Yes.